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EFFECT OF THE CONSOLIDATED ROCK PRODUCTS DECISION ON RAILROAD REORGANIZATIONS UNDER SECTION 77

CHRONIC financial distress has plagued American railroads, and financial reorganization has come to be the standard avenue of escape. But effective rehabilitation techniques remain a matter for controversy. Dissatisfaction with the cumbersome equity receivership and the acute need for overhauling railroad financial structures precipitated by the depression led to the enactment in 1933 of remedial legislation under the bankruptcy power.[1] But

1. Section 77 of the BANKRUPTCY ACT, 47 STAT. 1474 (1933), 11 U. S. C. §205 (1934).

practical defects which subsequently became apparent in Section 77[2] resulted in its complete revision in 1935.[3] Since that time experience and investigations[4] have led to the proposal and consideration of additional measures[5] designed to accelerate the procedure and clarify the general standards of Section 77 as amended, but no additional legislation has been enacted.[6] The abortive attempts at legislative improvement of Section 77 were prompted by fears, based upon past experience, that the statute might provide an unsatisfactory vehicle for reorganizing the larger railroad properties. The problems which were envisaged as most likely to cause difficulty under Section 77 can be broadly categorized into two groups: procedural problems in effecting expeditious reorganizations and formulation of proper standards to test fair and equitable plans compatible with the public interest. Foremost among the procedural issues was the need for precise definition of the respective functions of court and Commission in reorganization.[7] The problem of standards was largely concerned with the extent to which past and prospective earning power should control value determinations under Section 77.[8]

2. See *Hearings before Committee on Judiciary on H. R. 6249*, 74th Cong., 1st Sess. (1935) 13-16, 26, 32, 281; Wehle, *Railroad Reorganization under Section 77 of the Bankruptcy Act: New Legislation Suggested* (1934) 44 YALE L. J. 197; Craven and Fuller, *The 1935 Amendments of the Railroad Bankruptcy Law* (1936) 49 HARV. L. REV. 1254.

3. 49 STAT. 911 (1935), 11 U. S. C. § 205 (1940).

4. See REPORT OF COMMITTEE ON INTERSTATE COMMERCE PURSUANT TO S. RES. 71, 74th Cong., 1st Sess., contained in *Hearings before Committee on Interstate Commerce on S. 1869*, 76th Cong., 1st Sess. (1939) 135-215; REPORT OF COMMITTEE APPOINTED BY THE PRESIDENT OF THE UNITED STATES TO SUBMIT RECOMMENDATIONS UPON THE GENERAL TRANSPORTATION SITUATION (1938) 25-30.

5. The Wheeler-Truman Bill was thoroughly considered by the Senate and passed by that body in 1939. See SEN. REP. No. 454, 76th Cong., 1st Sess. (1939); *Hearings before Committee on Interstate Commerce on S. 1869*, 76th Cong., 1st Sess. (1935); 84 CONG. REC. 6209-45, 6311 (1939). The McLaughlin Bill was introduced in the House in 1940. 86 CONG. REC. 4770 (1940).

6. In 1939, roads which were only temporarily afflicted by the blight of depression were afforded expeditious relief by the enactment of Chapter XV of the Bankruptcy Act. 53 STAT. 1134 (1939), 11 U. S. C. §§ 1200–55 (1940). The act permitted solvent roads whose prospects appeared good to make voluntary adjustments of bond interest or principal maturities without a full-fledged reorganization. Under this chapter, the Baltimore & Ohio was able to change its fixed interest on certain junior securities to a contingent basis temporarily and to extend maturities. *In re* Baltimore & O. R. R., 29 F. Supp. 608 (D. Md. 1939). The Lehigh Valley postponed certain interest for a five-year period and extended maturities. *In re* Lehigh Valley R. R. Co., 34 F. Supp. 753 (E. D. Pa. 1940). See also Ewen v. Peoria & E. Ry. Co., 34 F. Supp. 332 (S. D. N. Y. 1940); *In re* Montana, W. & S. R. R. Co., 32 F. Supp. 200 (D. Mont. 1940).

7. See *Hearings before Committee on Interstate Commerce on S. 1869*, 76th Cong., 1st Sess. (1939) 244-60; REPORT OF THE COMMITTEE APPOINTED BY THE PRESIDENT TO SUBMIT RECOMMENDATIONS UPON THE GENERAL TRANSPORTATION SITUATION (1938) 25-28.

8. See *Hearings before Committee on Interstate Commerce on S. 1869*, 76th Cong., 1st Sess. (1939) 265-88.

The background of present controversy in railroad reorganization stems from the Supreme Court's decision in *Consolidated Rock Products Company v. Du Bois.*[9] Although this case arose under Section 77B, the opinion of the Court announced broad rules applicable to reorganizations generally. In the *Consolidated* case a plan devised under Section 77B had been confirmed by the district court although no findings of value either with respect to the enterprise as a whole or with respect to the various classes of claims had been made or attempted. The Supreme Court held that a plan of reorganization could not be approved by the court where adequate valuation data were lacking. The opinion stated that valuation of operating properties in reorganization should be based upon a capitalization of prospective earnings. The decision further clarified standards of fairness applicable under present reorganization procedure. Requirements of financial feasibility may necessitate the allocation of inferior types of securities in the new company to senior classes of creditors. But to satisfy fair and equitable standards, the Court indicated that the proposed allocation must "fully compensate" the senior claimant for his lost rights before junior interests may participate.

The rules enunciated in the *Consolidated Rock Products* case settled perplexing issues in reorganization procedure under Section 77B and Chapter X. But, since certain differences in statutory machinery exist between those portions of the Act and Section 77, the impact of the case upon the latter statute was left in doubt. The problem of construing Section 77 in light of the *Consolidated Rock Products* decision has confronted the Circuit Courts of Appeals for the Seventh and Ninth Circuits in three recent cases —the *Western Pacific,*[10] the *St. Paul,*[11] and the *Chicago & Northwestern*[12] reorganizations.

In all three cases, plans formulated after lengthy hearings before the ICC[13] had been approved by the district courts.[14] In each of the cases, stockholders who were eliminated from participation in the reorganization objected to the amount and character of total capitalization figures established by the Commission. And certain classes of creditors objected to the participation alloted them as compared with the allocations to other groups.

9. 312 U. S. 510 (1941). For the general implications of the case, see Dean, *A Review of the Law of Corporate Reorganizations* (1941) 26 Corn. L. Q. 537; Gilchrist, *"Fair and Equitable" Plan of Reorganization: A Clearer Concept* (1941) 26 Corn. L. Q. 592; Comment (1941) 18 N. Y. U. L. Q. Rev. 459; Comment (1941) 51 Yale L. J. 85.

10. *In re* Western P. R. R., 124 F. (2d) 136 (C. C. A. 9th, 1941).

11. *In re* Chicago, M., St. P. & P. R. R., 124 F. (2d) 754 (C. C. A. 7th, 1941).

12. *In re* Chicago & N. W. Ry., C. C. H. Bankr. Serv. (3d ed. 1941) ¶ 53,619 (C. C. A. 7th, 1942).

13. Western P. R. R. Reorganization, 230 I. C. C. 61 (1938), *modified,* 233 I. C. C. 409 (1939); Chicago & N. W. Ry. Reorganization, 236 I. C. C. 575 (1939); Chicago, M., St. P. & P. R. R. Reorganization, 239 I. C. C. 485 (1940).

14. *In re* Western P. R. R., 34 F. Supp. 493 (N. D. Cal. 1940); *In re* Chicago & N. W. Ry., 35 F. Supp. 230 (N. D. Ill. 1940); *In re* Chicago, M., St. P. & P. R. R., 36 F. Supp. 193 (N. D. Ill. 1940).

The lower court orders approving the ICC plans were reversed in the *Western Pacific*[15] and *St. Paul*[16] cases. This result was specifically based upon the *Consolidated Rock Products* decision. Both courts indicated that under Section 77(e) the judge must exercise an independent judgment on the fairness of proposed plans, and, relying upon the *Consolidated Rock Products* case, both held that the ICC's findings of fact on valuation data were insufficient to enable the district courts to exercise their statutory duties intelligently. In the *St. Paul* case the court appeared to reach this result reluctantly.[17] The opinion indicated that there was ample evidence in the record and in the Commission's report to support the plan in all its aspects. But the *Consolidated Rock Products* case, deemed controlling, was held to require precise findings of fact by the Commission which had not been made. The same result was avoided in the *Chicago & Northwestern* case by the court's holding that the requirement of fuller findings of fact on valuation data was waived in view of the overwhelming support of the

15. The capital structure of the *Western Pacific* road prior to reorganization was comparatively simple. In addition to trustee's certificates and equipment obligations which were left undisturbed, the debtor had first mortgage 5% bonds, collateral notes, unsecured claims and preferred and common stocks outstanding. The unsecured claims and stocks were found by the ICC to have no value and were accorded no participation. The notes were held by the RFC, RCC and the A. C. James Co., and were secured largely by securities of the debtor, its subsidiaries and affiliates. The only stockholder, a holding company, objected in the courts to the capitalization of the enterprise established by the ICC. The collateral noteholders objected to the relative distribution of securities among themselves. In reversing the lower court order, the Circuit Court of Appeals for the Seventh Circuit held that the report and order of the Commission did not contain sufficient findings of fact in regard to the value of the property as a whole, the value of the claims of each class of creditors, and the value of new securities to be issued by the reorganized corporation. Because of the lack of essential findings as to value, the court indicated that it was in no position to exercise its statutory function.

16. The capital structure of the *St. Paul* road was complex. In the courts, stockholders who had been eliminated from participation objected to the capitalization of the enterprise. On appeal they introduced recent statistics to the effect that gross operating revenues in early 1941 had increased 22.8% over 1940 and estimated that the income available for fixed charges in 1941 would be substantially increased. The *St. Paul* had six main divisions prior to reorganization, each covered by a first lien and junior mortgages. Various divisional mortgage bondholders objected to their proportionate participation. After reviewing the evidence and report of the Commission, the court held that there was ample support for the finding of no value in the stockholder interests, even if recent earnings were considered, and indicated that the total capitalization figure established by the ICC was equivalent to a finding of value for the enterprise as a whole. In regard to the relative disposition of securities among the various classes of creditors, however, the court held that the ICC had not made sufficient findings of fact in valuing the various creditor interests. Hence the court could not intelligently exercise its statutory function in reviewing the plan.

17. See *In re* Chicago, M., St. P. & P. R. R., 124 F. (2d) 754, 765 (C. C. A. 7th, 1941).

plan by creditors and the insignificant holdings of objectors. Hence, the order of the trial court approving the plan was affirmed.[18]

In both the *St. Paul* and *Chicago & Northwestern* cases, the court attempted to formulate standards to guide the ICC in making its value determinations. It indicated that prospective earning power — the test enunciated in the *Consolidated* case — is the primary factor to be considered in valuing properties for reorganization purposes. However, the court indicated that this rule was qualified in its application to railroad reorganizations by the express wording of Section 77(e).[19]

Reversal of the *Western Pacific* and *St. Paul* orders will delay the consummation of those reorganizations for at least another eighteen months. The Supreme Court will probably grant petitions for certiorari in both cases.[20] If the appellate court rulings are upheld, the plans will revert to the Commission for the requisite findings of value. Even if the Supreme Court reverses and holds that sufficient valuation data are available to permit an intelligent exercise of the court's statutory function, the cases must again be remanded to the Circuit Courts of Appeals for a determination that the plans are fair and equitable. Further uncertainty has been caused by the action of the district court in remanding part of the *New York, New Haven & Hartford* reorganization to the Commission.[21] And following the *Western Pacific* and *St. Paul* decisions, the district court requested parties to file statements in the *Chicago, Rock Island & Pacific* reorganization showing cause why that plan should not be remanded to the Commission on similar

18. Objections raised in the *Chicago & Northwestern* case were similar to those made in the *St. Paul* case. The court again ruled against the objections of stockholders in regard to the amount and character of total enterprise value, holding that the Commission had found a total capitalization figure for the system, that the evidence amply supported the figure, and that the court, in exercising its independent judgment, agreed with the Commission's finding that the equity of the stockholders was without value. 96.2% of the creditors voting accepted the plan. Only one class of creditors, the holders of a comparatively small issue of divisional lien bonds, failed to accept the plan by the requisite two-thirds majority. The District Court had made a specific finding that the plan was fair and equitable as to this group and approved it over the objection. Approximately one-third of the creditors did not vote. But the appellate court, indicating its whole-hearted indorsement of the plan, declared that it accepted the responsibility for protecting them and voted their interests in favor of the plan. The support of the creditors was deemed to operate as a waiver of the requirement of fuller findings. In view of Case v. Los Angeles Lumber Prod. Co., 308 U. S. 106 (1939), the waiver argument seems unsound.

19. See *In re* Chicago, M., St. P. & P. R. R., 124 F. (2d) 754, 763, 764, 766 (C. C. A. 7th, 1941); *In re* Chicago & N. W. Ry., C. C. H. Bankr. Serv. (3d ed. 1941) ¶ 53,619 (C. C. A. 7th, 1942).

20. Petitions for certiorari have been filed in all three cases. (1942) 10 U. S. L. WEEK 3214, 3247, 3276.

21. *In re* New York, N. H. & H. R. R., D. Conn., Dec. 8, 1941. A new plan meeting the objections raised by the court has recently been presented to the ICC. N. Y. Times, April 5, 1942, § 3, p. 1, col. 6.

grounds.[22] But despite the additional delay and the cloak of uncertainty shrouding pending cases, the most perplexing problems confronting courts and Commission under Section 77 are narrowly defined and presented in these cases. Consequently, the prospects of a comprehensive Supreme Court review of these issues makes the outlook on the railroad reorganization front more promising.

For purposes of discussion, the problems arising out of Section 77 as construed in these recent cases will be grouped under two heads — procedural problems, and standards of valuation applicable to railroad reorganization in view of the express wording of Section 77(e) and the rule announced in the *Consolidated Rock Products* decision.

Procedural Problems

Function of Court and Commission. Petitions under Section 77 are presented to a district court which assumes jurisdiction over the property of the railroad.[23] Operation of the road continues under a trustee subject to the supervision of the court.[24] Plans of reorganization are submitted by the parties to the ICC and hearings are held on the plans before that body, all interested parties being permitted to intervene.[25] The Commission certifies its approved plan to the court and must render a report in which it is required to state fully the reasons for its conclusions.[26] A transcript of the proceedings before the Commission must also be submitted to the court. The court is then directed to receive written objections to the proposed plan and hold hearings on such objections.[27] After the hearing, if the plan is approved, the Commission submits it to creditors of each class for acceptance or rejection,[28] and the plan is then sent to the court for final disposition.[29] If the court does not approve the plan, it may refer the proceedings back to the Commission or dismiss, in its discretion.[30] As a prerequisite to approval, the court must be satisfied, *inter alia*, that the plan conforms to the requirements of subsection 77(b), is fair and equitable, and provides for proper participation by various interests.[31]

Failure to define completely and specifically the respective areas of activity of court and Commission has been a source of considerable confusion in construing Section 77. Moreover, no cases directly involving the issue have been presented to the Supreme Court, although it has cursorily touched on

22. (1941) 154 Comm. & Fin. Chron. 1541.
23. Section 77(a).
24. Section 77(c) (1) and (2).
25. Section 77(d).
26. *Ibid.*
27. Section 77(e).
28. *Ibid.*
29. *Ibid.*
30. *Ibid.*
31. *Ibid.*

the matter.[32] A variety of interpretations has come from lower courts which have dealt with the problem. At one extreme are cases in which the "public" functions of the Commission are distinguished from the more prosaic determinations of private legal rights by courts.[33] These public functions presumably include the technical phases of reorganization — the ascertainment of total capitalization, formulation of a new security structure, and the outlining of the financial details to be included in the new securities issued. These matters are alleged to be solely for Commission determination and should be held conclusive on the courts unless it is shown that the Commission applied improper standards, or that its finding is wholly unsupported by the evidence.[34] Support for this argument can be found in the structure of Section 77. Under 77(d) the Commission, as a prerequisite to its approval of a plan, must be satisfied that it conforms to subsections (b) and (e) and "will be compatible with the public interest." The court under 77(e), on the other hand, is not required to make a finding that the plan conforms to the public interest.

An intermediate approach has confined the function of the court to correcting the Commission for errors of law and setting aside findings of fact not supported by the evidence.[35] Other tribunals have merely accepted the Commission's figures, expressing confidence in the superior experience of that body in making technical determinations, and have thus avoided the issue of the weight to be accorded Commission conclusions.[36]

At the opposite extreme are decisions which regard the duties of the court in more comprehensive terms. These cases express the view that all important phases of reorganization proceedings call for an informed, independent judgment on the part of the court which is not concluded by any determination made by the Commission, even in the case of technical valua-

32. Warren v. Palmer, 310 U. S. 132, 138 (1940); Palmer v. Massachusetts, 308 U. S. 79, 87 (1939). In both cases the court indicated that the administrative functions of the Commission and the judicial functions of the courts work cooperatively under §77. In the latter opinion the court stated that district courts were not given, under this legislation, the same scope as to bankrupt railroads that they have in dealing with other bankrupt estates. But the court made no attempt to define this scope of authority.

33. *In re* Western P. R. R., 34 F. Supp. 493 (N. D. Cal. 1940), *rev'd*, 124 F. (2d) 136 (C. C. A. 9th, 1941); *In re* Erie R. R., 37 F. Supp. 237 (N. D. Ohio 1940). See Swaine, *Present Status of Railroad Reorganizations and Legislation Affecting Them* (1941) 18 N. Y. U. L. Q. REV. 161, 171.

34. *In re* Western P. R. R., 34 F. Supp. 493, 501 (N. D. Cal. 1940), *rev'd*, 124 F. (2d) 136 (C. C. A. 9th, 1941); *In re* Erie R. R., 37 F. Supp. 237, 244 (N. D. Ohio 1940).

35. *In re* Chicago, M., St. P. & P. R. R., 36 F. Supp. 193, 202-03 (N. D. Ill. 1940), *rev'd*, 124 F. (2d) 754 (C. C. A. 7th, 1941); *In re* Missouri P. R. R., 39 F. Supp. 436, 442 (E. D. Mo. 1941).

36. *In re* Chicago & N. W. Ry., 35 F. Supp. 230 (N. D. Ill. 1940), *aff'd*, C. C. H. Bankr. Serv. (3d ed. 1941) ¶53,619 (C. C. A. 7th, 1942); *In re* Chicago G. W. R. R., 29 F. Supp. 149 (N. D. Ill. 1939).

tion data.[37] This argument is based upon prior Supreme Court decisions and upon the express mandate of 77(e).

Under Section 77 as it now stands, the last argument appears to be the most plausible. Congress apparently constituted coordinate authorities in the administration of railroad properties in reorganization. Even if Supreme Court cases reiterating the informed, independent judgment rule in other situations are not entirely applicable under Section 77,[38] at least the judge must perform his express statutory duties in passing upon proposed plans. The judge must be satisfied, *inter alia,* that a plan complies with subsection (b) of Section 77, is fair and equitable, duly recognizes the rights of and does not discriminate against each class of creditors and stockholders, and conforms to the law of the land in regard to participation.[39] Moreover, additional testimony may be taken in the courts, although this is apparently a limited practice.[40] And, although Congress has frequently endowed the findings of administrative bodies with substantial authority on review,[41] it chose not to do so here. On the whole, the statute seems to contemplate unlimited attack on plans in the courts despite the fact that the judge can-

37. *In re* Western P. R. R., 124 F. (2d) 136 (C. C. A. 9th, 1941); *In re* New York, N. H. & H. R. R., D. Conn., Dec. 8, 1941; *In re* Denver & R. G. W. R. R., 38 F. Supp. 106 (D. Colo. 1940).

38. The rule that courts must exercise an informed, independent judgment in passing on proposed plans of reorganization developed under equity receivership procedure where plans were formulated initially by the parties themselves and were then submitted to the court for approval. The underlying purpose of the rule was to insure an adequate judicial check on the fairness of the plan. National Surety Co. v. Coriell, 289 U. S. 426, 436 (1939); First Nat'l Bank of Cincinnati v. Flershem, 290 U. S. 504, 525 (1934). The same rule has been carried over into reorganization proceedings under the bankruptcy power. Case v. Los Angeles Lumber Prod. Co., 308 U. S. 106, 115 (1939) (77B proceeding); Consolidated Rock Prod. Co. v. Du Bois, 312 U. S. 510 (1941) (77B proceeding); American United Mutual Life Ins. Co. v. Avon Park, 311 U. S. 138 (1940) (Chapter IX proceeding). Under § 77, however, the same reasons for applying the rule are not so apparent, inasmuch as initial formulation of railroad reorganization plans rests with the competent ICC and complete review by the courts constitutes a double check. The situation is different even from Chapter X where the SEC exercises an advisory function only and the bulk of authority in effecting plans is exercised by the courts.

39. Section 77(e).

40. Swaine, *Present Status of Railroad Reorganizations and Legislation Affecting Them* (1941) 18 N. Y. U. L. Q. REV. 161, 178. In some courts, additional testimony has been taken and exhibits introduced. But apparently the scope of such testimony is limited. *In re* Chicago & N. W. Ry. (N. D. Ill., Order No. 420, June 27, 1940); *In re* Chicago & E. I. Ry. (N. D. Ill., June 16, 1939); *In re* Chicago G. W. R. R., 29 F. Supp. 149, 154 (N. D. Ill. 1939); *In re* Erie R. R., 37 F. Supp. 237, 242 (N. D. Ohio 1940). In other cases, judges have held informal conferences with interested parties. *In re* Denver & R. G. W. R. R., 38 F. Supp. 106 (D. Colo. 1940); *In re* Louisiana & N. W. R. R., 36 F. Supp. 636 (S. D. N. Y. 1938).

41. See, *e.g.,* SECURITIES EXCH. ACT, 48 STAT. 901-02 (1934), 15 U. S. C. § 78y (1940); PUBLIC UTILITY ACT, 49 STAT. 834-35 (1935), 15 U. S. C. § 79 (1940); FEDERAL TRADE COMM. ACT, 52 STAT. 112-13 (1938), 15 U. S. C. § 45(c) (1940).

not "dot an i or cross a t"[42] but must refer the plan back to the Commission for constructive amendment.[43] The argument distinguishing between "public" and "private" functions is patently inadequate. A finding of total capitalization may in one sense be a "public" function, yet, in order to be satisfied that a plan is fair and equitable to private interests, the judge would be compelled to review that finding. The same observation applies to other determinations of value. If the judge is satisfied that a particular class of creditors receives fair participation, he must likewise be satisfied that the underlying determination of value is fair.[44] In addition, the statute specifically provides for judicial review of the permissible amount of fixed charges,[45] a function which would normally be classified as "public". It is, therefore, unlikely that Congress intended any comprehensive classification of functions on a "public-private" rationale.

But whatever the theory voiced by the lower courts in regard to their duties under the statute, in practice there has been a natural tendency to accord considerable weight to Commission conclusions. In few cases has judicial review resulted in a detailed criticism of plans approved by the ICC.[46] Under present procedure, the incentive for critical analysis appears to be tempered by the desire of judges to permit the lengthy proceedings to terminate at the earliest moment.[47] The desirability of suggesting minor adjustments is overbalanced by the prospects of putting into effect what on the whole appears to be a good plan.[48]

42. See remarks of Senator Wheeler during debate on the proposed Wheeler-Truman Bill. 84 CONG. REC. 6210 (1939).

43. Section 77(d) provides that "no plan shall be approved or confirmed by the judge unless the plan shall first have been approved by the Commission and certified to the court."

44. See *In re* New York, N. H. & H. R. R., D. Conn., Dec. 8, 1941, where the court stated: "I cannot forget that the first paragraph of subdivision (e) requires the judge to approve the plan only 'if satisfied that it . . . is fair and equitable . . . and does not discriminate against any class of creditors, etc.' Construing the Act as a whole, I think it means that the judge, although without power to make any effective proposals as to value, is required to act upon an independent intelligence in approving a plan for its fairness, even though that ultimate issue involves underlying values."

45. The judge must be satisfied, under §77(e), that the plan conforms to the provisions of §77(b). One of the provisions of §77(b) states that a plan shall provide fixed charges in relation to the expected course of income. §77(b)(4).

46. In two cases the review of the courts appears to have been especially thorough. *In re* New York, N. H. & H. R. R., D. Conn., Dec. 8, 1941; *In re* Denver & R. G. W. R. R., 38 F. Supp. 106 (D. Colo. 1941). In the latter case, the district judge had handled an earlier equity receivership proceeding involving the same road.

47. This is illustrated by the reluctance of the court to reverse in the *St. Paul* case, and its adoption of the tenuous "waiver" argument as a basis for affirming the *Chicago & Northwestern* plan. See p. 970 *supra*.

48. Some courts have frankly declared their desire to see proceedings terminate. ". . . the plan is a good plan, and . . . there comes a time in all reorganization proceedings when it is much more desirable to get the property out of court under a good plan than it is to delay the matter in court in order to attempt to formulate a perfect

This is a familiar story in reorganization. Plans submitted to a tribunal after years of preparation have generally been approved. This was true of the courts under the equity receivership procedure,[49] and was largely responsible for the ineffectiveness of the Interstate Commerce Commission's check on plans of reorganization following the legislation of 1920.[50] A different result could hardly be expected under Section 77, where the initial preparation of a plan rests in the hands of so competent an authority as the ICC. Moreover, experience testifies that the formulation of a plan of reorganization for complex railroad properties is a unitary problem. Although the ICC has indicated that strictly legal problems are for court determination, it has been compelled to decide all legal issues in order to perfect its plans. In the *Western Pacific* case, for example, the Commission spent considerable time in determining the extent of the lien of first mortgage bondholders under an after-acquired property clause.[51] The coordinate functions of court and Commission now contemplated in the statute do not in practice provide an additional protection to investors sufficient to outweigh the delay involved. In the light of past experience and of the inherent difficulties entailed in complete judicial review in this type of case,[52] any immediate change in the attitude of the courts does not seem likely.

Legislation recognizing and correcting this aspect of Section 77 is desirable. The function of formulating a plan of reorganization should be vested in one body. This result could be achieved in one of two ways — by adopting a procedure similar to Chapter X, in which the office of the Commission would be advisory only[53] and the bulk of authority would remain with the

plan." *In re* Chicago & N. W. Ry., 35 F. Supp. 230, 257 (N. D. Ill. 1940); *cf.* Chicago & E. I. Ry., N. D. Ill., June 16, 1939.

49. The court's functions in scrutinizing plans under equity receivership procedure were greatly curtailed by the undesirability of upsetting the work of months or years once the plan reached the court stage. See SEC REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1940) Pt. VIII, p. 51; Craven and Fuller, *The 1935 Amendments of the Railroad Bankruptcy Law* (1936) 49 HARV. L. REV. 1254, 1256.

50. In 1920 the Commission was given power to approve all issues of railroad securities. 41 STAT. 494 (1920), 49 U. S. C. § 20a (1940). As was true of the courts, however, the Commission could exercise little effective control because plans reached that body at a late stage of the proceedings. "The Commission has not rejected outright any of the forty odd plans submitted to it since 1920, though in a few cases it has required minor changes." MOULTON, THE AMERICAN TRANSPORTATION PROBLEM (1933) 325.

51. See Western P. R. R. Reorganization, 230 I. C. C. 61, 97-100 (1938).

52. Adequate judicial review of ICC plans is circumscribed by the great complexity of facts and figures involved in these proceedings. When the Commission has spent years developing a proposed plan, the judge could hardly be expected to review it comprehensively in all its phases without a corps of trained assistants.

53. Section 172 of Chapter X requires the reorganization judge to submit plans which he considers worthy of consideration to the SEC for examination and report where the scheduled indebtedness exceeds $3,000,000. Where the scheduled indebtedness is less, the

courts, or by according the Commission greater powers and confining the scope of judicial review. In view of the established procedure, the general experience gained by the Commission in dealing with railroad reorganization problems, and its greater opportunity for access to economic data, the latter alternative seems the more expedient. Provision might be made for the initial formulation of a plan of reorganization by an independent trustee. This would curtail the present tendency of committees to submit plans largely for bargaining purposes. Under present procedure controlling groups can make excessive original demands, through the proposal of plans favorable to themselves, in the hope that they will salvage the major part of those demands in the final plan. Interim operation would be left with the district court as at present, but the scope of judicial review on the plan itself should be confined to correcting the Commission for errors of law and setting aside findings not supported by substantial evidence. The structure of appeal should be simplified. Appeal from the Commission on the completed plan could be heard by a three-judge district court with review by petition for certiorari to the Supreme Court.[54]

Necessity for and Sufficiency of Findings. The chief ground for reversing the *Western Pacific* and *St. Paul* orders was the lack of findings of fact on valuation data deemed necessary under the controlling mandate of the *Consolidated Rock Products* case. This problem has two phases — the necessity for and sufficiency of findings of total enterprise value, and the necessity for and sufficiency of findings of value for purposes of distributing reorganization securities among the various classes of claimants. These two phases involve somewhat different considerations.

A determination of total enterprise value serves several important functions in reorganization. In the first place, it serves a "foreclosure" purpose in making it possible to determine which classes of claimants are to be eliminated from participation.[55] It also has a "feasibility" function in providing

judge may in his discretion submit plans to the Commission. In both cases the reports submitted by the SEC are advisory only. Under § 173, however, the judge may not enter an order approving a plan until after the SEC has submitted its report if it decides to do so. The Commission may also, with the judge's approval, participate in the proceedings. (§ 208). Where liquidated indebtedness exceeds $250,000, the judge is required to appoint one or more trustees and he may do so if the indebtedness is less. (§ 156). Where a trustee is appointed, he prepares and files a plan before the debtor may propose plans. (§§ 169, 167). For a survey of the procedure under Chapter X see Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act* (1941) 18 N. Y. U. L. Q. REV. 317.

54. This shortened appeal procedure was adopted under Chapter XV. § 713. The special three-judge court created under that section was ranked with a Circuit Court of Appeals in the weight to be accorded its conclusions. See Ackert v. Baltimore & O. R. R., 115 F. (2d) 455, 457 (C. C. A. 4th, 1941).

55. This is the function performed by the judicial sale in ordinary mortgage foreclosure proceedings.

for a capitalization of the reorganized company which will permit advantageous future financing.[56] Closely analogous is the "watered stock" function. A plan of reorganization should not,[57] and, under many state statutes, cannot be approved if it provides for the issuance of securities without full value behind them.

Apparently the drafters of Section 77 did not intend that a valuation of the property should be necessary in all cases.[58] The statute is ambiguously worded but does not specifically require a finding of total enterprise value.[59] Nor has the Commission adopted a practice of making a finding of total enterprise value as such. Rather it has set out fully its subordinate findings in regard to such valuation factors as reproduction cost new less depreciation, book investment, the physical value of the debtor's land, investments in affiliated companies, and past and prospective earnings usually capitalized at a rate of 5%.[60] In the great majority of cases the Commission has set a maximum permissible capitalization of the enterprise[61] without specifically weighting the various factors considered by it in making the judgment.

56. There is no specific requirement that a proposed railroad reorganization plan be "feasible." *Cf.* § 221(2) of Chapter X and § 366(3) of Chapter XI. Substantially the same requirement is contained in § 77(b)(4) providing that the total permissible fixed charges must be related to earning power and in § 77(d) requiring plans to be "compatible with the public interest."

57. See pp. 984–85 *infra.*

58. See *Hearings before Committee on Judiciary on H. R. 6249,* 74th Cong., 1st Sess. (1935) 150-51, 317.

59. Section 77(e) says only that "if it shall be necessary to determine the value of any property for any purpose under this section . . ." that valuation shall be made with due consideration for certain specified factors. But the Act does not state when a valuation is necessary. Section 77(e) also provides that it shall not be necessary to submit plans to stockholders if the Commission shall have found, and the judge shall have affirmed the finding, that the equity of the stockholders was without value. The Commission has apparently regarded this latter provision as specifying the only precise finding necessary with respect to value. Where stockholders have been eliminated, the ICC has uniformly made a specific finding that their equity was without value. See, *e.g.,* Western P. R. R. Reorganization, 230 I.C.C. 61, 100 (1938); Chicago & E. I. Ry. Reorganization, 230 I.C.C. 199, 233 (1938); Chicago & N. W. Ry. Reorganization, 236 I.C.C. 575, 637 (1939); St. Louis S. W. Ry. Reorganization, 249 I.C.C. 5, 166 (1941). A further specific finding of insolvency has not been deemed necessary by the ICC under § 77. See St. Louis-S. F. Ry. Reorganization, 242 I.C.C. 523, 526 (1940).

60. See, for example, Chicago R. I. & P. Ry. Reorganization, 242 I.C.C. 298, 429–38 (1940); New York, N. H. & H. R. R. Reorganization, 239 I.C.C. 337, 397 (1940); Chicago & N. W. Ry. Reorganization, 236 I.C.C. 575, 578–87 (1939); Western P. R. R. Reorganization, 230 I.C.C. 61, 67–76 (1938).

61. In a few cases, the majority of them early, the ICC has failed to indicate specifically the maximum permissible capitalization. Copper Range R. R. Reorganization, 212 I.C.C. 479 (1936); Chicago, S. S. & S. B. R. R. Reorganization, 212 I.C.C. 547 (1936); Kansas City, K. V. & W. R. R. Reorganization, 221 I.C.C. 15 (1937); Reader R. R. Reorganization, 221 I.C.C. 190, 603 (1937); Savannah & A. Ry. Reorganization, 224 I.C.C. 197 (1937); Spokane International Ry. Reorganization, 228

This determination of total maximum capitalization should be considered tantamount to a finding of value.[62] In at least one case the Commission has specifically indicated that the total capitalization figure established represented "the worth of the assets that will be devoted by the reorganized company to the service of transportation."[63] Such a determination, coupled with the full reporting of subordinate evidence and findings, clearly satisfies the ambiguous requirements of the statute. And it should also be sufficient under the *Consolidated Rock Products* case. That decision seems to compel a finding of value for the entire enterprise.[64] But to impose a requirement in railroad reorganizations that the Commission label its figure a "valuation" rather than a "total capitalization" would constitute merely a formal change in the method of presentation, and alone should not justify reversal. Moreover, the Commission sets out adequate supporting data, even if the various factors are not specifically weighted, to enable the judge to exercise his independent judgment on the capitalization figure established. The function of evidence in reorganization proceedings is to narrow the area in which the line of a plan can be charted. Within the given field much is left to experienced judgment. To require a detailed elaboration of the mental processes of the Commission in selecting its final figure does not seem necessary where ample subordinate findings are available.

In the *Western Pacific* case no maximum capitalization figure was established in the Commission's reports, although a finding was made that the claims of unsecured creditors and the equity of stockholders were without value.[65] In view of its importance in the reorganization process, a specific finding of total enterprise value or maximum capitalization does seem necessary. But the Commission approximated the setting of a maximum capitalization figure in the *Western Pacific* case when it proposed a new capital structure for the reorganized company[66] and this omission is not enough to justify reversal.

A second and equally important phase of the valuation problem involves the character of findings required in distributing reorganization securities

I.C.C. 387 (1938); Western P. R. R. Reorganization, 230 I.C.C. 61 (1938); Denver & R. G. W. R. R. Reorganization, 233 I.C.C. 515 (1939).

62. This was the approach taken in the *St. Paul* and *Chicago & Northwestern* cases. See notes 16 and 18 *supra*.

63. Chicago G. W. R. R. Reorganization, 228 I.C.C. 585, 642 (1938).

64. Consolidated Rock Prod. Co. v. Du Bois, 312 U. S. 510, 520 (1941).

65. Western P. R. R. Reorganization, 230 I.C.C. 61, 101 (1938).

66. Western P. R. R. Reorganization, 230 I.C.C. 61, 96 (1938). The Commission stated: "Upon the issue of the securities above approved . . ., the total capitalization, excluding 313,703 shares of no-par-value common stock, would be $62,326,217, consisting of $3,066,117 of equipment obligations, $10,000,000 of first-mortgage 4-percent bonds, $19,716,040 of income-mortgage 4-percent bonds, and $29,574,060 of 5-percent preferred stock. Treating the no-par-value common stock as $100 per share, the total capitalization would be $93,726,517." This capital structure was modified in minor details in 233 I.C.C. 409, 412–13 (1939).

among the various classes of claimants. The *Consolidated Rock Products* decision was premised in part on the theory that fairness in distribution requires a participation by various classes in proportion to the value of their claims. Since the security structures of the larger railroads in reorganization is extremely complex, a characteristic of the current group of reorganization proceedings has been the attempted simplification of these structures by substituting blanket mortgages for divisional mortgages as security for bonds,[67] and by consolidating into integrated systems various subsidiaries with separate securities outstanding.[68] The translation of these separate and conflicting claims into system values is an undertaking of considerable magnitude. Nevertheless, "at least an approximate ascertainment of their respective assets" must be attempted or "the issue of fairness of any plan of reorganization . . . cannot be intelligently resolved."[69]

The Commission has undertaken the task of establishing a fair distribution of securities between divisional mortgage bondholders by use of elaborate earnings segregation formulas,[70] severance studies,[71] and contributive income investigations.[72] Consideration is also given to the physical properties subject to the various liens. Past and prospective earnings, reproduction cost, and book value of subsidiary companies are considered in order to ascertain the approximate worth of their contribution to system operations.[73] The Commission has not, however, followed a practice of making precise findings of value for each claim involved. Nor has it attempted to define in other than par value terms the securities issued in reorganization. Instead, it has reported the results of its various studies and expressed its conclusions as to the relative values of the component parts only in terms of the par or stated value of new securities issued. The courts in the *Western Pacific* and *St. Paul* cases, basing their conclusions on the *Consolidated Rock Products* decision, have held that more precise findings of value are necessary.

It can be argued that the *Consolidated* case is not necessarily applicable to railroad reorganizations under Section 77. The statute does not make

67. See, *e.g.*, Chicago, M., St. P. and P. R. R. Reorganization, 239 I.C.C. 485 (1940); Chicago & N. W. Ry. Reorganization, 236 I.C.C. 575 (1939); Erie R. R. Reorganization, 239 I.C.C. 653 (1940).

68. See especially Missouri P. R. R. Reorganization, 239 I.C.C. 7 (1940).

69. Consolidated Rock Prod. Co. v. Du Bois, 312 U. S. 510, 525 (1941).

70. These formulas break down the revenues and operating expenses attributable to the various mortgaged sections of a railroad.

71. Severance studies are designed to measure the loss of system net income which would occur if the particular mortgaged line were operated as a separate system or by another railroad.

72. Contributive income investigations are undertaken in order to ascertain the benefit which the system as a whole derives from traffic originating or terminating on each mortgaged line.

73. See, *e.g.*, Missouri P. R. R. Reorganization, 239 I.C.C. 7, 32–45 (1940).

findings of fact on valuation issues mandatory but requires only that "the Commission shall state fully the reasons for its conclusions."[74] And the Commission reports have apparently satisfied that vague requirement. However, the further statutory requirement that a plan be found fair and equitable and that the proposed distribution of securities conform to the law of the land[75] would seem to make the *Consolidated* case applicable.

It can also be contended that the *Consolidated* decision itself does not compel complete findings by the Commission on valuation data. In that case the Supreme Court was confronted with a proposed plan where no adequate valuation data were present on the earning capacity of the property, no finding of total enterprise value predicated upon proper standards had been made, and no segregation of assets subject to the two bond mortgages had been attempted on any basis. Assuming that a total enterprise value based upon proper standards had been placed upon the property, and that a formula had been devised for segregating the values attributable to the two mortgage bond issues, a distribution of securities based upon the results of that formula might not have incurred the condemnation of the Court, even if no precise findings had been made with respect to the values of the respective liens surrendered. As long as all factors considered are fully set out, including the formulas themselves, the method pursued in their application, and the results obtained, the courts could presumably exercise their statutory function in determining whether the proposed distribution is fair and equitable. The area of judgment in appraising these conflicting claims is so great that requiring precise findings of value might mean only a translation of the Commission's actual distribution of securities into absolute values without any major alteration in the plan.

On the other hand, the *Consolidated* case prescribes definite standards of fairness in reorganization which extend beyond the confines of particular statutes. Fairness in participation is measured by the value of the claims surrendered and senior creditors must be fully compensated before junior interests are entitled to participate. The *Consolidated* decision should not be viewed as an attempt to straight-jacket reorganization procedure. The type and extent of inquiry and the method of presenting valuation data may well vary as occasion demands. The particular formula of distribution adopted will remain largely a matter of experienced judgment. Values in reorganization can at best only be approximated. But the standard remains fixed. If the full compensation rule is to be something more than a profession of doctrine, judgment must be predicated on specific findings as to the value of the claims surrendered and the worth of the new securities issued in exchange for those relinquished claims.

74. Section 77(d).
75. Section 77(e).

STANDARDS GOVERNING VALUATION

Much confusion in railroad reorganizations has been caused by the failure of both courts and Commission to establish definitive standards governing valuation and for this the uncertain directions contained in the statute are primarily responsible. Section 77(e) provides that due consideration shall be given to past, present, and prospective earning power and to all other relevant facts in valuing railroad properties. Unwarranted fears raised by previous Supreme Court dicta in regard to the inclusion of reproduction cost data in valuing railroads for rate-making purposes led to the enactment in 77(e) of the further provision that only such effect shall be given to reproduction cost and original cost as may be required by the law of the land.[76] While this section of the statute was apparently regarded by its drafters as merely cautionary and not as providing a formula for valuation,[77] it has not been so construed by either courts or Commission, and no attempt to adopt an exclusive earning power test has been made. Cost data have been considered on all issues of valuation. The Commission has asserted that its primary emphasis has been directed to earning power in formulating reorganization plans.[78] Yet its total capitalizations have been set at a figure substantially higher than those which would have resulted from the capitalization of past or prospective earnings.[79]

The *Consolidated Rock Products* decision should have allayed all fears as to the necessity for including cost data in determining valuation for reor-

76. In the historic decision of Smyth v. Ames, 169 U. S. 466 (1898), the Supreme Court declared that value determination for purposes of rate-making was a question of fact to be ascertained after consideration of all relevant facts. Those facts included original cost, amounts expended on permanent improvements, the market value of bonds and stocks, present cost of construction, probable earning capacity under the particular rates prescribed, and the sum required to meet operating expenses. In a later decision, the Supreme Court reversed the Commission because of its failure to include reproduction cost as an element of value in determining rate-base valuation. St. Louis & O'Fallon Ry. v. United States, 279 U. S. 461 (1929). Consequently, in drafting § 77, it was feared that these decisions required inclusion of reproduction cost and original cost as elements of value. See *Hearings before Committee on Judiciary on H. R. 6249*, 74th Cong., 1st Sess. (1935) 30. A recent decision by the Supreme Court has emasculated the rule of *Smyth v. Ames* in this connection. Reproduction cost need no longer be considered as an element of value even for rate-making purposes. The reasonableness of the rates proposed by a regulatory body is the extent of the court's inquiry — not the method of determining those rates. Federal Power Comm. v. Natural Gas Pipeline Co., (1942) 10 U. S. L. WEEK 4274 (U. S. 1942).

77. Craven and Fuller, *The 1935 Amendments of the Railroad Bankruptcy Law* (1936) 49 HARV. L. REV. 1254, 1275, n. 64.

78. See Western P. R. R. Reorganization, 230 I.C.C. 61, 87 (1938); Erie R. R. Reorganization, 239 I.C.C. 653, 717 (1940); Chicago, R. I. & P. R. R. Reorganization, 242 I.C.C. 298, 390–91 (1940); Chicago & N. W. Ry. Reorganization, 236 I.C.C. 575, 671 (1939) (concurring opinion).

79. See Comment (1941) 54 HARV. L. REV. 655, 662.

ganization purposes. Nevertheless, the rule announced in that case was regarded as qualified by Section 77(e) in the *St. Paul* and *Chicago & Northwestern* opinions.[80] Although the Supreme Court did not specifically reject or define the applicability of physical appraisals in the *Consolidated* case,[81] its emphasis was placed solely upon earning power.[82] In view of the legislative background of Section 77(e), it would seem that the *Consolidated* case is not qualified by the statute but goes far in clarifying it. Congress in 1935 would probably have sanctioned earning power as the sole test of value had it not been plagued by Constitutional doubts. Apparently those doubts alone[83] were responsible for inserting in the statute the provision that reproduction and original cost should be considered in a negative manner — only to the extent required by the law of the land. Consequently, the *Consolidated* case, by implying that a consideration of cost data is not required under the law of the land, would seem to sanction the adoption of past, present, and prospective earnings as the sole determinant of value under Section 77(e).[84] No reason is apparent for distinguishing between standards applicable to industrial concerns and railroads in reorganization. It can be argued that,

80. *In re* Chicago, M., St. P. & P. R. R., 124 F. (2d) 754, 763, 764, 766 (C. C. A. 7th, 1942); *In re* Chicago & N. W. Ry., C. C. H. Bankr. Serv. (3d ed. 1941) ¶ 53,619 (C. C. A. 7th, 1942).

81. The court reversed because no consideration at all had been given to earning power in determining value.

82. See Consolidated Rock Prod. Co. v. Du Bois, 312 U. S. 510, 526 (1941). The court stated: ". . . 'the commercial value of property consists in the expectation of income from it.' . . . Such criterion is the appropriate one here, since we are dealing with the issue of solvency arising in connection with reorganization plans involving productive properties. It is plain that valuations for other purposes are not relevant to or helpful in a determination of that issue, except as they may indirectly bear on earning capacity." The SEC has adopted the prospective earning power test of value for operating properties in reorganization. The Higbee Co., Corporate Reorganization Release No. 39, March 25, 1941; Deep Rock Oil Corp., 7 S. E. C. 174, 181 (1940); Jome, *The New Schoolmaster in Finance* (1942) 40 MICH. L. REV. 625, 632-33; Comment (1941) 51 YALE L. J. 85, 88-92; Comment (1941) 55 HARV. L. REV. 125. The SEC has rejected reproduction cost new less depreciation as an adequate test. La France Industries, 5 S. E. C. 917, 926 (1939); National Radiator Corp., 4 S. E. C. 690, 695 (1939). Of course, liquidation values are relevant where a portion of the business or the whole enterprise will ultimately be discontinued. McKesson and Robbins, Inc., Corporate Reorganization Release No. 41, March 29, 1941; Penn. Timber Co., 4 S. E. C. 630 (1939).

83. See *Hearings before Committee on Judiciary on H. R. 6249*, 74th Cong., 1st Sess. (1935) at p. 30, where Mr. Leslie Craven, who drafted the valuation provision, stated: "We are afraid to come right out and say, 'You shall not consider reproduction cost.'" The whole tenor of the hearings indicates an attempt to read cost data out of reorganization valuation insofar as constitutionally possible. The Wheeler-Truman Bill, passed by the Senate in 1939, gave chief consideration to capitalized average annual earnings over the previous 12 years. See SEN. REP. No. 454, 76th Cong., 1st Sess. (1939).

84. See Spaeth and Windle, *Valuation of Railroads under Section 77 of the Bankruptcy Act* (1938) 32 ILL. L. REV. 517; but *cf.* Caplin, *Valuation and Earnings in Railroad Reorganization: A Consideration of the Proposed Amendment to Section 77* (1941) 27 VA. L. REV. 769.

because the earnings of a railroad are regulated by public authority and because rates set are based upon the valuation of the road, it would be a circular process to determine valuation in reorganization by earnings. This contention is not sound. The process of regulating railroads has largely shifted from the problem of reducing monopolistic rates to that of providing any return at all to an industry beset by an expanding competition.[85] Amendments to the Interstate Commerce Act have recognized this by providing an approach in determining rate levels which has largely supplanted rate-base valuation.[86] Moreover, the underlying basis for determining value varies with the function and purpose for which the resulting figure is intended. There is no necessary correlation between applicable standards of value for rate-making and for reorganization purposes.[87]

Forthright adoption of an earning power standard would go far in improving the entire procedure under Section 77. The inclusion of cost data as a vital factor in the valuation process has probably been one of the underlying reasons for the failure of the Commission to make definitive findings of value in passing upon plans of reorganization. The Commission may have feared attack on such findings in the courts because of the uncertainty of emphasis required by the statute to be placed upon cost data. Moreover, it would seem inherently difficult to assign specific weight to factors which would generally give such varying results as costs and earning power. Under present procedure it would always seem possible to direct a frontal attack on Commission plans in the courts by contending that the Commission result gave insufficient weight to either earnings or costs.[88] Adoption of the earnings test would also restrict the types of evidence to be offered in hearings, thus narrowing the ultimate area of judgment as well as eliminating the time-consuming presentation and consideration of cost figures. The available scope of attack on plans in the courts would likewise be reduced.

Adoption of the earnings test would not only expedite procedure; it would lead as well to the formulation of sounder capital structures. Over-

85. See 52d ANN. REP. I. C. C. (1938) 17; *Hearings before Committee on Judiciary on H. R. 10387*, 75th Cong., 3d Sess. (1938) 27-53.

86. 48 STAT. 220 (1933), 49 U. S. C. § 15(a) (1941). See *Hearings before Committee on Judiciary on H. R. 6249*, 74th Cong., 1st Sess. (1935) 44-45.

87. In Temmer v. Denver Tramway Co., 18 F. (2d) 226 (C. C. A. 8th, 1927), the court distinguished value for rate-making purposes from value in determining solvency and held that rate base value was not an adequate criterion for determining value for insolvency purposes. The view that valuation is purposive has been well-expressed in Spaeth and Windle, *Valuation of Railroads under Section 77 of the Bankruptcy Act* (1938) 32 ILL. L. REV. 517, 526. This approach has been adopted by the SEC. Jome, *The New Schoolmaster in Finance* (1942) 40 MICH. L. REV. 625, 632. The ICC has expressed similar views. See Chicago, R. I. & P. Ry. Reorganization, 247 I. C. C. 533, 539 (1941).

88. Objections of this nature appear to have been made in the *St. Paul* case. See *In re* Chicago, M., St. P. & P. R. R., 124 F. (2d) 754, 760 (C. C. A. 7th, 1941).

valuation may not result in overcapitalization if fixed charges are properly related to the expected course of income. However, overvaluation may well lead to excessive stock issues not properly correlated to earnings and create a "watered stock" problem.[89] The possibilities for future stock financing are thereby curtailed. And if, in lean years, interest cannot be paid on income bonds, financing through that medium on advantageous terms becomes impossible. Resort to fixed-interest debt securities results and the enterprise is started on the road to another reorganization.

Greater emphasis upon earning power would likewise seem advisable in view of the "full compensation" rule announced in the *Consolidated Rock Products* case. In that decision, the Supreme Court declared that senior classes of security holders must be fully compensated for their lost rights before junior security holders are entitled to participate in reorganization. Moreover, "prior rights are not recognized . . . if creditors are given only a face amount of inferior securities equal to the face amount of their claims."[90] The ICC has in some cases distributed common and preferred stocks to creditor interests in partial satisfaction of their claims while also permitting stockholders to participate in reorganization.[91] Feasibility may properly require the issuance of inferior securities to bondholders in satisfaction of their claims.[92] But inasmuch as fairness requires that the treatment accorded bondholders be fully compensatory, some approximate ascertainment of the value attributable to the new securities would seem necessary. And that value must be ascertained in more precise terms than the par or stated value of the new securities.[93] A thorough analysis of new securities in terms of prospective earnings would seem to be the most expeditious method of determining those values.[94]

89. See Comment (1941) 54 HARV. L. REV. 655, 658.

90. Consolidated Rock Prod. Co. v. Du Bois, 312 U. S. 510, 525 (1941).

91. Erie R. R. Reorganization, 239 I. C. C. 653 (1940), *approved, In re* Erie R. R., 37 F. Supp. 237 (N. D. Ohio 1940); Chicago G. W. R. R. Reorganization, 228 I. C. C. 585 (1938), *approved, In re* Chicago G. W. R. R., 29 F. Supp. 149 (N. D. Ill. 1939). See Comment (1941) 51 YALE L. J. 85, 105-06.

92. Consolidated Rock Prod. Co. v. Du Bois, 312 U. S. 510, 528 (1941).

93. Gilchrist, *"Fair and Equitable" Plan of Reorganization: A Clearer Concept* (1941) 26 CORN. L. Q. 592, 619.

94. The SEC has adopted the test of evaluating new reorganization securities in terms of book value predicated upon prospective earnings. See McKesson and Robbins, Inc., Corporate Reorganization Release No. 41, March 29, 1941, pp. 24-25; *cf.* La France Industries, 5 SEC 917, 930-32 (1939).